The Corporate Alternative Minimum Tax: Adjusted Current Earnings

An Honors Thesis (HONRS 499)

by

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Abstract

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The Alternative Minimum Taxable Income (AMTI) of a corporation is modified by Adjusted Current Earnings (ACE). Enacted under the Tax Reform Act of 1986, the basic objective of the Alternative Minimum Tax is to force certain taxpayers to pay an additional tax which more accurately depicts their profit. The ACE adjustment equals 75 percent of the difference between the adjusted current earnings of a corporation's AMTI, determined before including the ACE adjustment and any AMT Net Operating Loss deduction. The ACE adjustment is a hybrid method based on both earnings and profits concepts, as well as regular tax concepts. Although extremely costly and complex to calculate, the ACE adjustment seeks to impose at least some tax liability on all corporations.

The Corporate Alternative Minimum Tax: Adjusted Current Earnings

Today's tax complexity is the result of a tax legislation process which is greatly influenced by lobbyists, campaign fundraisers, budget watchers and others who wish to initiate or discourage certain activities. The U.S. tax system is founded on voluntary compliance. The complexity of the U.S. tax system has eroded this foundation and reduced revenues (Starkman 1990). Further, this complexity requires hours of expensive talent and extensive paperwork. The first step towards tax simplification is to develop a vocal constituency for tax simplification. The second step is to reform the tax legislation process (Starkman 1990). Due to today's large deficit, any simplification proposals must be "revenue neutral", because the U.S. government cannot afford to reduce revenues.

The Alternative Minimum Tax

Currently, one of the most complex issues in corporate accounting concerns the Adjusted Current Earnings Adjustment (ACE). The ACE adjustment is an adjustment to the Alternative Minimum Taxable Income (AMTI) of a corporation. Historically, the government has not required conformity between tax accounting and financial accounting. For many years the only direct conformity requirement was that if the LIFO method was used for tax accounting, the Internal Revenue Code (IRC) also had to be used for financial accounting (Section 472(c)). With the ACE adjustment, the U.S. Congress is attempting to impose at least some tax liability on all corporations. A corporation may still choose to use different methods for tax and financial accounting purposes, however, the result will be an ACE adjustment. Because the ACE adjustment is a complex calculation in itself, and several implementation issues need yet to be resolved, many compliance problems exist (Craig 1990). The Congress of the U.S. formulated and passed the Tax Reform Act of 1986 to achieve three goals: greater fairness, simplicity, and efficiency in the tax system (Degler 1989). The basic objective of the Alternative Minimum Tax is to force certain taxpayers to pay an additional tax which more accurately depicts their profitability.

The Original "Add-on" Alternative Minimum Tax

The first minimum tax was enacted in 1969. Just prior to this enactment, a Treasury Department report was released which indicated that a significant number of high-income taxpayers were paying little to no income tax because of the use of certain tax advantages (Degler 1989). Specifically, tax preferences were the major problem of misuse. Tax preferences favor those groups who are able to take advantage of the preferences, and transfer the tax burden to those who are unable to take advantage of the preferences. A proper minimum tax should act as a "backstop to push taxpayers back into the regular tax system in order to avoid minimum tax liability" (Degler 1989). Although theoretically an AMT would raise no additional revenues, revenue could be increased as a result of those taxpayers being forced back into the regular tax system. The original 1969 "add-on AMT" was revised by the Tax Reform Act of 1986. The AMT is imposed only to the extent it exceeds the regular income tax.

In computing AMT, two types of changes are made to taxable income. First, some items must be recalculated and added back to or deducted from taxable income. The corporate AMT rate of 20 percent is then applied to alternative minimum taxable income (AMTI) which exceeds a $40,000 exemption. The exemption is phased out at a rate of 25 percent for AMTI which exceeds $150,000 (Section 55(d)(2)(3)). For tax years 1987-1989, the book income or Business Untaxed Reported Profits (BURP) adjustment was in effect. As defined by Section 56(f) of the Internal Revenue Code, this adjustment was equal to 50 percent of the excess of adjusted net book income over AMTI, determined without regard to the BURP adjustment and AMT Net Operating Loss (NOL) deduction. For tax years beginning after December 31, 1989, the book income or BURP adjustment has been replaced by the ACE adjustment.

Computation of the ACE Adjustment

One of the most burdensome changes to the Corporate AMT rules enacted under the 1986 Tax Reform Act is the ACE adjustment. Several technical modifications were made to the ACE adjustment in Congress' Revenue Reconciliation Act of 1989. Although these modifications sought to simplify the calculations, they are still extremely complex. Section 56(g) of the Internal Revenue Code details the provisions for calculating ACE adjustments. The term "adjusted current earnings" is defined in Section 56(g)(3) to be AMTI for the taxable year as determined (1) before the ACE adjustment and AMT net operating loss deduction and (2) after several adjustments relating to the earnings and profits of the corporation.

The ACE adjustment equals 75 percent of the difference between the adjusted current earnings of a corporation's AMTI, determined before including the ACE adjustment and any AMT NOL deduction (Section 56(g)). The ACE adjustment may be negative, unlike the book income adjustment, which may only be positive or zero. The reduction, however, may not exceed the excess of the total amount by which the ACE adjustment increased AMTI in prior tax-years, less the total reduction taken in prior years (Section 56(g)(2)).

The ACE adjustment is actually a hybrid method based on both earnings and profits concepts, as well as regular tax concepts. Generally ACE applies to all corporations except Subchapter S Corporations, REIT's, REMIC's and RIC's (Section 56(g)). The ACE adjustment applies to the same taxpayers as the book income adjustment did. Because of the immense impact on corporate AMT calculations, the monitoring of corporate decisions on these calculations is of growing importance in modern corporate tax planning. The ACE adjustment does not lend itself to easy manipulation, such as the book income adjustment which effectively gave corporations an incentive to manipulate their book-income figure (Hunt and Pollard 1990).

ACE is effective for taxable years beginning after December 31, 1989. Because of this, corporate taxpayers who had short years in 1989 or who incurred no tax liability in 1989, may have been affected by ACE as early as April 16, 1990, the due date of the first quarter estimated tax payment (Craig 1990). Large corporations are required to make estimated tax payments based upon the greater of AMT or regular tax, and therefore must consider the ACE adjustment to avoid underpayments. Smaller corporations must also be cautious, as non-compliance now may cause future risks, for the ACE calculation is extremely complex. The determination of the cumulative ACE balance in later years will be costly and difficult to calculate if a corporation has failed to keep track of the adjustment accurately each year.

ACE Depreciation

One of the most cumbersome components of ACE is depreciation. Preliminary AMTI is adjusted for depreciation by substituting allowable ACE depreciation for AMT depreciation. First, ACE depreciable basis is determined. Depreciation is then computed by calculating depreciation for all applicable property, based on the ACE depreciable basis, by both the ACE and book methods. Then the present value of future deductions, is calculated using ACE and book methods. Allowable ACE depreciation is the depreciation computed under the method which results in the lowest present value. The depreciation adjustment is the difference between AMT and regular tax computed depreciation (Section 56(g)(4)(A)(i) and (v)).

Adjusted Current Earnings Basis

The ACE basis is determined by separating property into four categories, according to when it was placed in service. The first category consists of property placed in service after 1989. Depreciation for these assets is calculated using the alternative depreciation system (ADS). The ACE depreciation on these assets is calculated by taking straight-line depreciation over the ADS class life. This expense amount calculated is then compared to the AMT depreciation expense. If AMT depreciation expense is greater than ACE depreciation, the difference is a positive adjustment to preliminary AMTI (PAMTI). If the opposite occurs, a negative adjustment is made to PAMTI.

The second category of property consists of Modified Accelerated Cost Recovery System (MACRS) property, property placed in service after 1986 and before 1990. The calculation for these assets is done by taking the AMT adjusted basis of such assets as of the end of the taxable year beginning before 1990 and applying the straight-line method over the remaining ADS recovery period given in Section 168(g). The recovery period begins on the first day of the first taxable year beginning after 1989 and ends on the last day of the recovery period that would have applied had the recovery period for the property originally been determined under Section 168(g)(2). The ACE depreciation expense is then compared to AMT depreciation expense. If the AMT depreciation expense is greater than ACE depreciation, the adjustment is positive to preliminary AMTI. If the opposite occurs the adjustment will be deducted from PAMTI.

The third class of assets consists of property placed in service after 1980 and before 1987, ACRS property. The calculation for these assets is done in the same manner as for assets placed in service after 1986, except that regular tax adjusted basis is used instead of AMT adjusted basis. This adjustment is determined under Regulation 1.56(g)-1(b)(2)(iii). ACE depreciation is still straight-line over the remaining ADS recovery period. The difference is that ACE depreciation is compared to regular tax depreciation. The difference between regular tax and ACE depreciation is then used to either increase or decrease preliminary AMTI.

The final class of assets consists of that property which is placed in service before 1981. Because the regular tax and the ACE depreciation expense are then the same, no further adjustment is required.

Computation of ACE Depreciation Components

Because of the numerous and time consuming calculations comprising the depreciation component of the ACE adjustment, it is wise to compute it annually, even if it is not used. If it is not computed annually, in any future year when it is used, one must go back and do the calculations, a very costly and time consuming task.

Although tedious, the calculations are rather straight-forward. The following simplified examples illustrate this calculation. (1) A copier placed in service on January 1, 1990, at an acquisition price of $10,000.00, would be classified in the first class of property. Using the regular tax method for 5 year MACRS property, regular tax depreciation would be $2000.00 ($10,000 X 20%), for 1990. Assuming the half-year convention, AMT depreciation would be calculated using the 5 year 150% Declining Balance (DB) AMT method, resulting in $1500.00 ($10,000 X 15%) of depreciation for 1990. ACE depreciation expense for 1990 would be calculated using the ADS recovery period, resulting in an expense of $1000.00 ($10,000 X 10%). In 1990 a $500.00 AMT depreciation adjustment would be necessary, as regular depreciation is greater than AMT depreciation. Finally, an ACE depreciation adjustment of $500.00 would also be necessary, as AMT depreciation is greater than ACE depreciation. Succeeding depreciation expenses would be calculated in a similar manner.

(2) Office equipment placed in service on June 30, 1987, for $200,000.00, would be calculated using the 7 year MACRS method, resulting in 1990 depreciation expense of $24,980.00. Assuming the half-year convention, AMT depreciation expense would be calculated using the 10 year 150% DB AMT method, resulting in 1990 expense of $20,049.00. ACE depreciation expense for 1990 would be calculated using an ADS recovery period of 10 years, and result in $17,821.00. Again, an AMT depreciation adjustment of $4931.00, and an ACE adjustment of $2228.00 are necessary.

(3) A building, purchased at a cost of $400,000.00 on January 1, 1984, would be classified in group three as ACRS property. Regular tax depreciation would again be calculated in

1990 using the regular 15 year ACRS method, and would cause $24,000.00 of depreciation expense. Assuming a mid-month convention and using the AMT straight-line method for 15 year property, $26,667.00 depreciation expense would result in 1990. The ACE depreciation expense would be calculated using a 40 year ADS recovery period, and would result in a $5647.00 expense in 1990. An AMT depreciation adjustment is not made, as pre-1987 tax preferences may not result in negative adjustments. In 1990, the ACE depreciation adjustment is $18,353.00 which represents the excess of regular tax depreciation over ACE depreciation.

(4) Furniture purchased at a cost of $150,000.00 on June 30, 1980, would be classified in class four. For 1990, regular tax and ACE depreciation expense would be calculated using a 10 year Double Declining Balance, and result in an expense of $4920.00. No ACE depreciation adjustment is required, as the regular tax and ACE depreciation expense are the same.

Other AMT Adjustments

Although the depreciation component is the most common adjustment, there are other items which affect preliminary AMTI. Next, certain tax-exempt items are added to the ACE deduction. This section includes tax-exempt interest less certain related deductions, life insurance proceeds and federal tax refunds. For years there have been proposals to place a tax on the income build-up in life insurance policies. The ACE adjustment meets this objective. The inside build-up consists of the increase in the net surrender value of the insurance policy during the taxable year less premiums paid by the policy holder during the year (Snyder 1990). Upon the death of the insured, the excess of the death benefit over the taxpayer's adjusted basis in the contract for purposes of computing ACE is included in ACE. Any inside build-up prior to 1990 is not included. An adjustment to ACE is made by subtracting the build-up from the life insurance. Build-up is calculated by computing the increase in the net surrender value, plus the cost of life insurance provided, less the amount of premiums paid net of the policy holder dividends. The cost of the life insurance is the lesser of two calculated amounts, either the cost of the individual insurance on the life of the insured determined on the basis of uniform premiums, or the mortality charge, if any, stated in the contract. The income build-up on an annuity contract originally required a slightly different calculation, but has currently been repealed. Build-up in this case referred to the excess of the sum of the net surrender value of the contract as of the close of the year, plus all the distributions under the contract received during the year or any prior year, reduced by the sum of the amount of the net premiums under the contract for the year and prior years and amounts includable in gross income for prior years. Although income from annuity contracts was to be included in the ACE calculation, the rules relating to annuities were repealed by RRA of 1989 (Craig 1990). Still another modification states that income under Section 108, from a discharge of indebtedness, is also excluded from the ACE computation (Craig 1990).

Items Not Affecting ACE

Earnings and profits (E&P) represent an entity's economic well being. According to Section 56(g)(4)(B), items of income that are excluded for regular and AMT purposes, but are included in computing earnings and profits are included in computing ACE in the same manner as if they were includable in gross income for purposes of computing AMTI. Tax-exempt interest, increases in insurance policy cash surrender value, deferred gain on certain installment sales and interest income from loans used to acquire employer securities under Section 133 are examples of items to be included in determining income (Klein and Deaver 1990).

Items which are deductible for earnings and profits but not for regular tax or AMT are not deductible for ACE, unless the deduction relates to an item included in income. Therefore, such items as fines, penalties, the disallowed portion of meals and entertainment, disallowed golden parachute payments, political contributions, and federal income taxes do not have an effect on the ACE adjustment. Carrying charges related to tax-exempt interest are, however, deductible for the ACE adjustment (Klein and Deaver 1990).

Conversely, Section 56(g)(4)(B) disallows items not deductible in computing earnings and profits. An exception exists, however, for certain dividends-received deductions. The 80 percent dividends-received deduction is allowable for ACE if the dividend is received from a 20 percent owned corporation, but only to the extent such dividend is attributable to income of the paying corporation which is subject to tax by the United States. The 100 percent dividends-received deduction is also allowed if the corporation is 80 percent or more owned, and provided also that the income of the paying corporations is subject to tax by the United States (Section 56(g)(4)(C)).

AMTI Modifications

Under Section 56, four specific earnings and profits items are modified for ACE purposes. A corporation must capitalize and amortize over a 60 month period intangible drilling costs paid or incurred in taxable years beginning after December 31, 1989 (Section 56(g)(4)(D)(i)).

Secondly, corporations may not amortize circulation costs (Section 248) which are paid or incurred after December 31, 1989. Instead, these expenses must be included in the basis of the asset they helped to create (Section 56(g)(4)(D)(ii)).

Further, corporations must make an adjustment for the change in the LIFO recapture amount for any taxable year beginning after December 31, 1989. ACE is to be adjusted upward or downward by increases or decreases in the LIFO reserve which is the amount by which FIFO inventory exceeds LIFO inventory (Section 56(g)(4)(D)(iii)).

Finally, beginning with the original TRA of 1986, ACE must be computed without regard to the installment method. This rule does not apply to dispositions before 1990, where the installment method applies in computing ACE to the same extent that it applies in determining pre-adjustment AMTI. After RRA of 1989, a modification stated that the prohibition remains the same, except for cases where interest is paid, as prescribed by Section 453(A). The installment sales method may now be used in calculating this ACE component, since the interest is effectively paid for the right to defer the applicable tax liability (Snyder 1990). No ACE adjustment need be made for the portion of installment obligations which provides for the interest charge on deferred gain (Section 56(g)(4)(D)(iv)). Generally, installment obligations that in the aggregate exceed $5 million are subject to an interest charge on the deferred gain (Section 453A(a)(1)).

Under Section 453A, interest is charged on the "applicable percentage" of gain realized from installment sales during a year. The applicable percentage is determined by applications of Section 453(A)(c)(4), by dividing the aggregate amount of outstanding installment obligations in excess of $5 million at the end of a taxable year by the total outstanding installment obligations at the close of such year. Therefore, the "applicable percentage" gain is not includable in ACE in the year of transaction and is accorded installment treatment for ACE purposes. However, the balance of the realized gain not subject to the interest charge is not accorded installment sale treatment for ACE.

There exist several other adjustments that must be made to PAMTI. According to Section 56(g)(4)(G), depletion allowances with respect to any property placed in service in a taxable year beginning after 1989 should be calculated using the cost method.

If a corporation undergoes an ownership change under Section 382 in a taxable year beginning after 1989 and there is no unrealized built-in loss, certain reductions may have to be made in the asset bases (Section 56(g)(4)(H)). This reduction in basis will reduce future ACE depreciation. Upon disposition of the assets, the ACE gains and losses will be recomputed with regard to the new bases. Determination of whether Section 382 rules apply must be made independently for both regular tax and ACE purposes. It is quite probable that Section 382 will not apply for regular tax purposes but will affect ACE. Section 56(g)(4)(E) dictates that no loss may be recognized on the exchange of any debt pools having substantially the same effective interest rates and maturities. Finally, acquisition expenses of life insurance companies must be capitalized and amortized in accordance with the treatment required under generally accepted accounting principles (Section 56(g)(4)(F)).

Compliance and Planning Problems

There exist many compliance issues, which represent certain implications when computing the ACE adjustment. Several rather detailed points regarding depreciation still remain unclarified. ACE depreciation expense is to be calculated applying the appropriate earnings and profits method to an "ACE depreciable basis". The ACE depreciation provisions do not specify which depreciable basis is to be used when calculating ACE depreciation for property acquired before 1981. Further, ambiguity also surrounds the depreciation computation for pre-1981 property when an accelerated method has been used for regular tax purposes (Craig 1990). There also exists uncertainty when calculating ACE depreciation for cars and light trucks. The annual ACE depreciation deductions could be greater than those allowed under regular tax if the current ADR midpoints are used.

Corporate taxpayers may also encounter certain compliance problems with ACE "exclusion" items. An exclusion item for ACE purposes is defined as an item of income or expense that is included in earnings and profits, and therefore ACE, but excluded from regular tax or AMTI. Although the TRA of 1986 and the RRA of 1989 Conference Committee reports cite examples of these exclusion items, a complete listing is not provided. These exclusion items may be significant for some corporations, and may even be significant enough to trigger AMT (Craig 1990).

The ACE adjustment also plays a large role in planning considerations. The primary objective is to minimize the difference between ACE and AMTI before ACE and the AMT NOL deduction. Although the impact was lessened by the RRA of 1989, corporations usually find that one of their significant adjustments relates to tax-exempt interest. Accordingly, firms should consider shifting their investment portfolios away from tax-free bonds. This avoids or at least minimizes the adjustment (Craig 1990). Firms contemplating switching to the LIFO method must be aware that the ACE adjustment will continue to lessen the value of the LIFO election (Craig 1990). The LIFO election is therefore less attractive to firms who are subject to AMT, as changes in "LIFO reserves" must be included in the ACE computation. Finally, it is very advantageous for a firm to generate a negative adjustment. This adjustment must be timed correctly, however, as the negative adjustment may only be used to reduce AMTI if the net of all prior year's ACE adjustments exceeds the current year's planned reduction.

Summary

The corporate alternative minimum tax improves the overall fairness of the tax system, and the ACE adjustment seeks only to strengthen this goal. The AMT strives to generate revenue based more upon economic income than financial income. Because of the ACE adjustment especially, AMT now incorporates a modified earnings and profits element. The new rules, however, are very complex and place a considerable administrative burden on accountants. Currently, the depreciation adjustments for ACE are disadvantageous to capital-intensive corporations. Because of the burden on manufacturing and production firms, serious questions arise as to the intent of Congress. Also, legislation should be added to allow for a provision to carry over negative ACE adjustments.

The vast complexity of the ACE adjustment requires that the computations be made annually. There exists little room for short-cuts, for if ACE is not computed yearly, whether or not the corporation will be subject to AMT or not, the complexity will only be compounded. Although complex and time consuming, the ACE adjustment simply seeks to alleviate the unfairness of timing differences and seeks to impose at least some tax liability on all corporations.

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